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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

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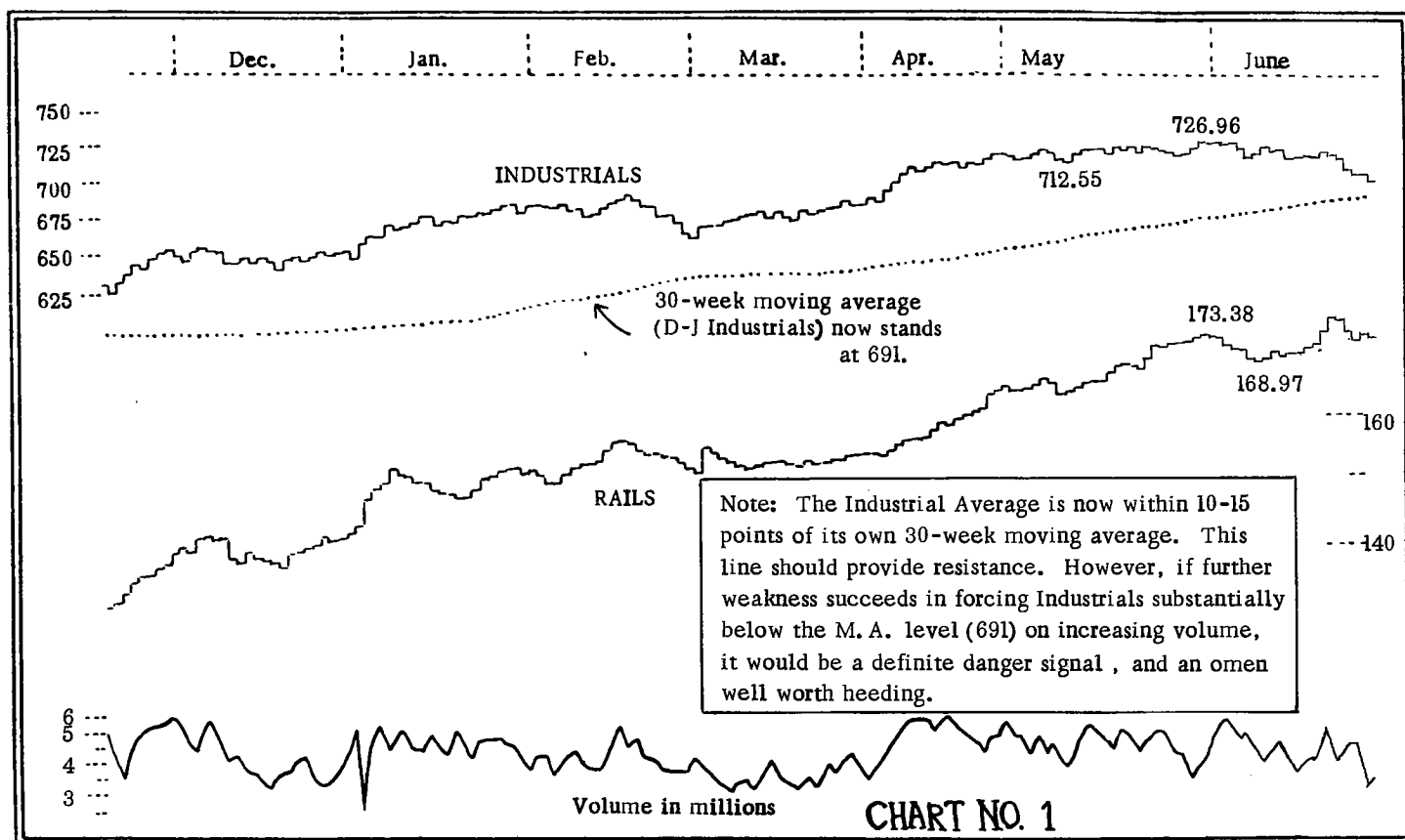
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THE MARKET On May 31 the Industrial Average recorded a post-crash recovery high of 726.96, while Rails established a peak of 173.38. A minor decline ensued, followed by a second rally. On the second rally the Rail Average rose to a fresh recovery peak of 176.19 (a movement which took the carriers above their 1959 high of 173.56).

DOW THEORY: From the standpoint of Dow's Theory, the move contained obvious elements of danger. For despite the remarkable Rail strength, the Industrial Average failed by six points to better its May 31 high. As stated in the last Letter: "It is well to remember that a refusal by one Average to confirm the penetration of the other can lead to an important reversal."

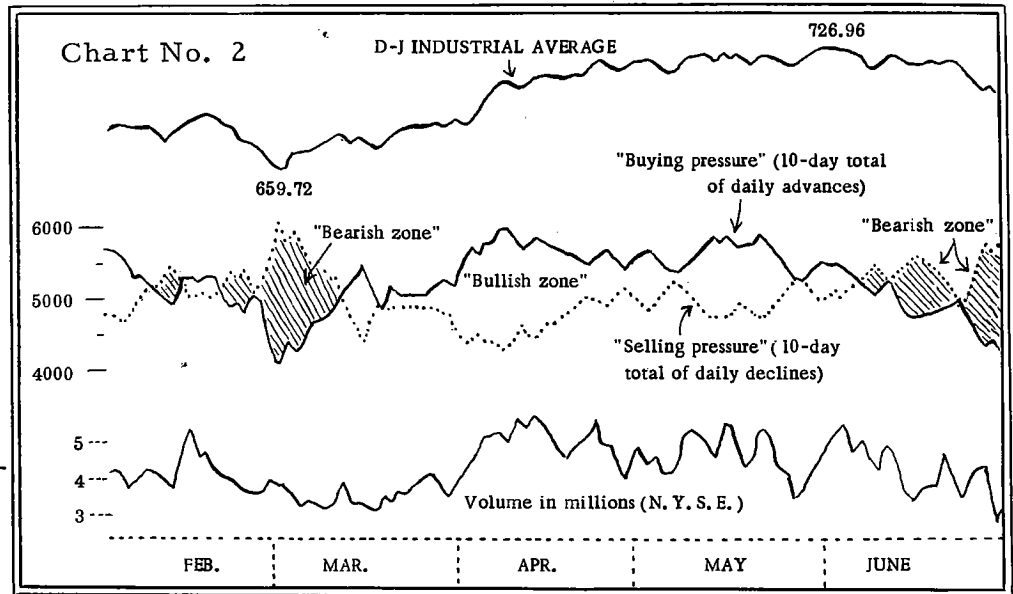
For forty-five trading days (April 23 to June 25) Industrials held within a 2% price range. During that period a total of 213 million shares of stock changed hands. On June 26 Industrials dropped below the long trading area (below 712.55), and this suggested that a good deal of distribution had taken place. Nevertheless, just as the Rail recovery high (unconfirmed by Industrials) was not a sign of strength, so the Industrial violation of the 712.55 level cannot be considered a definite sign of weakness unless confirmed by a comparable decline in the Rail Average (below 168.97). A persistent refusal by Rails to violate 168.97, in fact, could lead to a good recovery.

FURTHER COMMENT: It is interesting to note that the advance-decline ratio touched its peak along with the Industrial Average on May 31. Such action is not typical of major bull market tops, and in fact the long record of the A-D ratio and the Industrial Average shows that almost all major bull movements ended with obvious weakness in the general market (as measured by the A-D ratio) while the "blue-chip" Industrial Average was rising to successive new highs. The most recent of such examples was the long divergent period during 1959 when the A-D ratio declined and new highs were recorded by Industrials. This action was followed by the 1960 sell-off. Again during 1961 the A-D ratio touched a peak in May; this was



Page 2 followed by a new high in the Industrial Average in December. Further divergence occurred in early 1962, and the market caved in during the second quarter of that year.

Obviously, if Industrials rise to new recovery highs (above 726.96) and the A-D ratio refuses to confirm, we will have a classic danger signal. Nevertheless, the question arises, can a serious decline start from a situation in which both the Industrial Average and the A-D ratio establish highs together? The answer is, on occasion—yes, but those occasions have occurred within rallies (upward reactions) in bear markets. For instance, a bear market started in March, 1937. The first long decline terminated in July, followed by a rise into August, 1937. On August 14, both Industrials and the A-D ratio touched recovery highs and turned down together. This was followed by the disastrous bear market which ended in 1938.



In 1931 (during the course of the great bear market) a singular and deceptive (upward) correction occurred. Both the Industrial Average and the A-D ratio rallied from their May lows to peaks recorded in June. A minor decline ensued, followed by another rally which took the A-D ratio to a further recovery peak. This peak, however, was not confirmed by Industrials. Subsequently, the market collapsed to year-end lows. Thus during that bear market a period was seen during which the general market actually out-performed the Industrial Average -- only to be followed by a major extension of the bear trend.

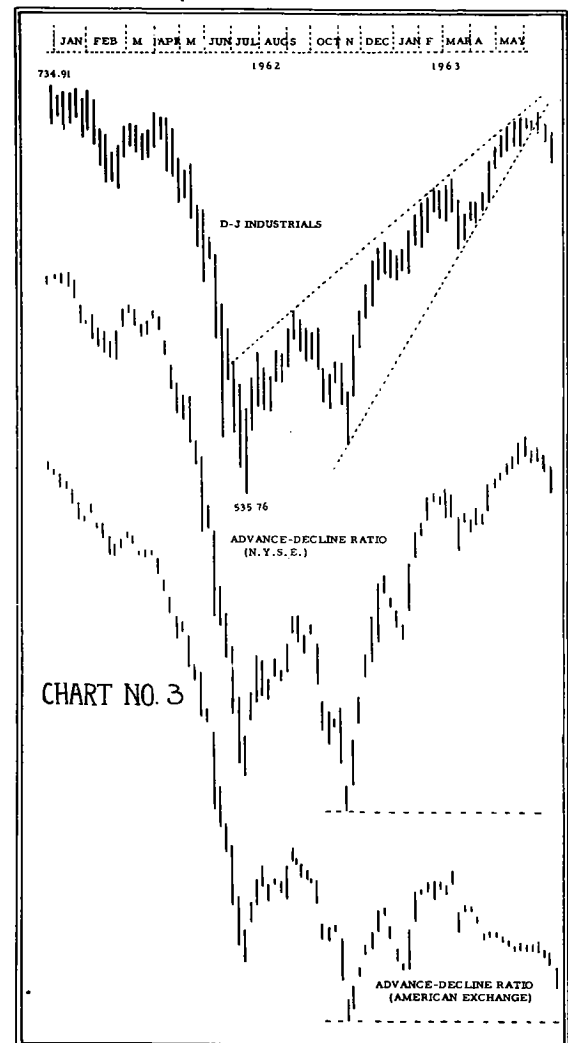
In other words, during major bull movements the A-D ratio almost always provides warnings of coming reactions. But during bear markets it is not unusual for both indicators to turn down together.

BUYING AND SELLING PRESSURE The selling pressure line continues in the dominant position. After two attempts at a bullish recrossing (each attempt failed -- see chart No. 2), the selling line has now risen to its highest level since February, while buying has dropped to the lowest level since February. This study has performed well -- as early as June 6 it alerted us to the possibility of danger ahead. The longer the selling line now holds above buying, and the heavier the market volume while this relationship exists, the more bearishness we are entitled to read into the situation.

BIG PICTURE The accompanying chart (No. 3) appears in these Letters periodically. It is a weekly chart (arithmetically scaled), and it shows the position of three important indicators -- the D-J Industrial Average, the advance-decline ratio on the N. Y. S. E. and the A-D ratio on the American Exchange.

I have referred in recent Letters to the huge wedge pattern which has been formed by the Industrial Average (see chart). This pattern has assumed a perfection of symmetry seldom seen in technical analysis, and it is, I feel, a formation which should be treated with the greatest respect. Referring to "Technical Analysis of Stock Trends" by Edwards & Magee, that authoritative book states: "A rising wedge on an arithmetically scaled weekly chart is almost invariably a bear market phenomenon, expressing as it does the diminishing vigor which is the normal property of any reaction against a prevailing primary trend."

During the week ending June 14 (see Letter 222) the great rising wedge in the Industrial Average was broken. If that pattern is to develop true to form, we can now expect a further (perhaps violent) decline, a slow, laborious recovery, and then a continuation of the decline. In other words, if all the action in the market since June, 1962, was part of an extended bear market rally, then it is here (as Industrials "fall out" of their wedge



pattern) that we should begin to see a resumption of the downward trend.

As seen on the same chart, the A-D ratio on the N.Y.S.E. has now sustained its third significant decline since October. This has occurred following a fair amount of technical deterioration (i.e., decline in new highs, "churning action", Industrials falling out of a wedge). I feel that there is a good chance that the A-D ratio has recorded its final peak for this rise -- but obviously, only time will tell.

The A-D ratio on the American Exchange presents an extraordinary picture. Note that this indicator has now broken below its June, 1962 "crash" low, and only the October, 1962 low stands between the American A-D ratio and what would seem to be fresh bear market lows. Very few analysts are cognizant of the drama now being played out on the American Exchange. To my mind, a great deal of significance should be attached to the American A-D ratio and the ability (or inability) of that indicator to hold above the October, 1962 low.

RALLYING RAILS Daily volume in the twenty stocks which compose the D-J Rail Average usually averages about 60 to 70 thousand shares per day. During the five days of May 21 to 27, volume in the D-J Rails ran respectively -- 207, 163, 229, 220 and 253 thousand shares. This together with the excited activity in the carrier Average prompted one astute local observer to write; "The Rail Average looks like it's 'blowing its top'".

On June 21 the Rail Average actually bettered its 1959 high of 173.56, and despite notable sluggishness on the part of Industrials, the carriers immediately extended their gains to a June 24 peak of 176.19. This move took Rails to within five points of their highest level of the entire 1949-63 period, the 181.23 mark which was recorded on May 9, 1956. (The only higher point ever touched by Rails was 189.11 on September 3, 1929).

"What does it mean," writes a subscriber, "that Rails went over their 1959 high, and what would it mean if they bettered their 1956 high?" In my opinion, if Rails better their 1956 high of 181.23 and if Industrials better their 1961 all-time peak of 734.91, the implication will be that the primary uptrend which began in June, 1949, has been reconfirmed and is still in effect.

The only comparable period (if the above theoretical action comes to pass) would have been the 1932-37 era. At that time a confirmation occurred in the Rail Average which was so fascinating that I feel it is worth discussing. During 1933 (see chart No. 4) both Averages surged up from their 1932 lows, with Rails establishing a peak of 56.53. A reaction took Rails to a low in 1935, followed by a renewed uptrend. Although Industrials continued their upward progress all through 1934 to 1937, it was not until late 1936 that the Rail Average finally confirmed the successive Industrial highs. Writing of the Rail confirmation, Robert Rhea said: "In the opinion of this writer, the fact that the Rails finally bettered the 1933 highs is of no particular forecasting significance because of the extreme age of the older objective. No similar condition was ever before recorded in the Averages. The event does, however, delight those students who demand complete fulfillment of every technical detail." (Sept. 26, 1936).

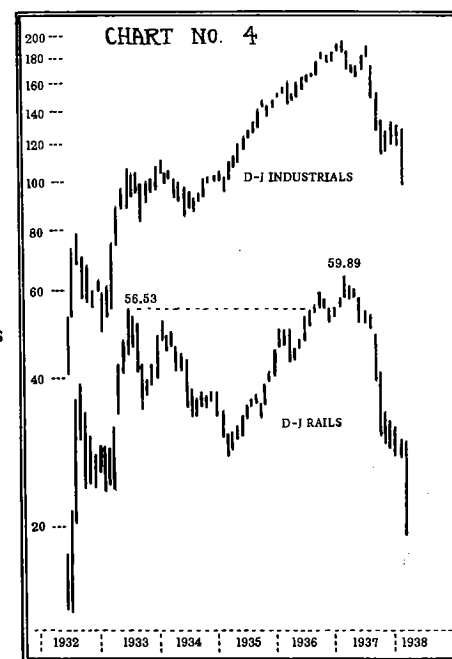
Rhea's scepticism proved warranted (see chart). In early 1937, following rather limited upside progress, the bull market ended. The Rail confirmation (which had arrived three years late) proved deceptive and disappointing.

If Rails now bettered the 1956 high of 181.23 we would have a situation much like 1936. Such a movement would constitute a reconfirmation seven years after the 1956 Rail peak. If and when it occurs, we will deal with it further.

MONEY, MONEY We have been reading for many months now about "oceans" of money that have been piling up in our savings institutions. Indeed, a number of institutions were said to be refusing new deposits of less than \$10 thousand (they did not want to be bothered with "small potato" deposits. Moreover they did not know what to do with all the money they had on hand).

The price that a savings institution has to pay for money is often an interesting commentary on the times. Below is a list of interest rates paid by the savings department of a typical U. S. commercial bank (this bank happens to be located in San Diego.) The list contains important rate changes for the past 31 years.

January, 1932 ----- 4%	June, 1935 ----- 2 1/2%	January, 1950 ----- 1 1/2%
June, 1933 ----- 3 1/2%	December, 1935 --- 2%	December, 1951 ----- 2%
December, 1933 ----- 3 1/4%	January, 1937 ---- 1 1/2%	January, 1957 ----- 3%
June, 1934 ----- 3%	January, 1938 ----- 1%	January, 1962 ----- 3 1/2%



Note the low rate (1% to 1 1/2%) paid by the banks during the 1937 to 1950 period. During much of that time common stocks were on the "bargain counter". In fact, average yields on the D-J Industrial Average were 7.09% in April, 1938; 7.15% in February, 1942; 6.84% in June, 1949. But despite the bargain blue-chips, the banks were able to retain all the money they wanted at a rate of 1% to 1 1/2%. In other words, during much of 1937-50 you could not "give stocks away" but banks provided almost no yield because the bank was where people wanted their money.

The situation is reversed today. Commercial banks now have to pay 3 1/2% for money (an extra 1/2% if they can have your money for over a year). Furthermore, despite requests by Federal authorities to reduce rates, many savings & loan associations on the West Coast have now actually raised their rates. And one of the oldest of such institutions shocked the industry over the past two weeks by raising dividends to 5%, while Mr. Bart Lytton, owner of a West Coast savings & loan association announced that "we are in a rate war" (New York Times, June 26, 1963).

All of this catches the market at a time when stocks are at historically high valuations. As Mr. Justin Barbour, a veteran market observer, recently put it: "At its recent high, it (the D-J Industrial Average) was selling for 19.38 times projected \$37.50 earnings. This is within 5% of the highest valuation the market ever put on record earnings."

Gauged by the return on one's money (i.e., yields), the market is saying that stocks are now in great demand (they pay only 3% or so) -- whereas nobody has any respect for money (insured savings institutions now have to pay 3.5% to 5% in order to attract money).

STOCKS Of 444 stocks which are carefully tabulated at this office each week, 312 or 70% are now holding above their 30-week moving average (a sharp drop of 11% from last week). Although this is the lowest bullish percentage since April 1, as long as 50% or more of the stocks remain above their M.A., this study remains bullish.

Stocks and stock groups go up and they go down. No group stays up forever, no group is depressed forever. This seemingly simple idea is expressed in the old Wall Street adage: "Don't tell me what to buy -- tell me when to buy it!" A fascinating illustration of this concept is provided by the relative strength line of the Rail group (see below).

During 1958 and early 1959 the Rails showed superior relative strength (trendline 1), but the public was not particularly interested in the market (or the Rails) at the time. Rail relative strength broke in March, 1959, and continued down for three years. But these three years (1959, 1960, 1961) were the years (trendline 2) when the public became vitally interested in the market. Since the Rails were acting poorly during that period, the public "wrote them off" as money-makers ("the Rail industry is dying"). In April of 1963 Rail relative strength turned up, and by early 1963 the bullish trendline (3) was established. Thus Rails have been outperforming the market since October, 1962, and if this strength continues Rails will shape up as the leaders on the next rally. Strongest in the group are Pennsylvania, N.Y. Central, Illinois Central, Southern Pacific, Missouri Pacific.

Ironically, I.B.M., the favorite of the institutions and the most talked about "growth" stock of the generation, now shows poor relative strength. The stock has traced a large rising wedge since June, 1962, and this is a formation which denotes gradually diminishing buying interest (note trend of volume). Over the past two weeks I.B.M. has fallen out of its wedge pattern. Who ever thought that there would be a time when N.Y. Central would look better than I.B.M.?

Charts on this page courtesy of Traders Research, P.O. Box 2466, St. Louis 16, Missouri.

